

2015-2016 Preliminary Budget

Economic Update

Executive Summary:

- *No substantive shift in the economy since the last publication on July 28, 2014.*
- *The Puget Sound Region continues to outperform the nation.*
- *Bellevue home prices have rebounded much faster than the nation.*
- *Employment in the region and in Bellevue has also fared better than the nation during and since the Great Recession.*
- *Overall, the City's forecast assumes a modest recovery of tax revenues over the next few years.*
- **Risks:**
 - *Global/National: Ukraine, China, Europe, and political gridlock.*

Economic Outlook:

It is generally believed the Federal Reserve Bank (The Fed) will taper off the Quantitative Easing program late this year. (Source: Forbes) The program is an unconventional tool the Fed has utilized when its usual tools are no longer effective controlling inflation and unemployment. This move indicates that the stated goals of the Fed, to keep unemployment and inflation to a targeted low have run its course and it is no longer needed. The economy is improving, but not at a rate that most economist would like to see during a recovery from a recession. On an individual basis, just short of half of the States have will have moved into an economic expansionary period in terms of employment by the end of 2014, meaning employment have surpassed their prerecession peak. (Source: Global Insight)

The economy is largely driven by consumer spending; Bellevue is particularly sensitive to this due to a large retail presence as well as many car dealerships. The factors that drive consumer spending are recovering well locally, with per capita income growing at a healthy pace and home price recovery outpacing the rest of the Puget Sound communities. These measures lead to more consumer spending. Bellevue has seen this in terms of sales tax collections.

The State of the Recovery:

The next step beyond recovery from an economic event such as the Great Recession is, traditionally, expansion. The Great Recession was different than the last few recessions because it hit people, literally, where they live -- in their homes. Many people lost their jobs and homes and even more people lost significant value in their homes. Home values were once seen as the safest investment one could make and then, unexpectedly, people often owed more than their homes were worth. For those who stuck it out and stayed in their homes, the lost value has now nearly been regained or even, in some instances in Bellevue, exceeds pre-recession levels.

2015-2016 Preliminary Budget

Economic Update

Global and National Risks on the Horizon

Risks have substantially remained the same since the beginning of the year, with many dragging on for years.

- **Trouble in the Ukraine.** Despite the Cold War being over for almost three decades, the post-Cold War map is still in flux. As trouble unfolds in Ukraine, world markets will be affected by the potential geopolitical implications of an East/West conflict. Ukraine is a significant exporter of grains and is the main conduit of natural gas to Western Europe from Russia. Economic sanctions have been placed on For Russia's support and apparent hand in the instability in Ukraine. While those sanctions are designed to be punitive measures for Russia, they may also have some blowback on the world economy in particular the European Union who depends on natural gas supply from Russia.
- **China's economic slowdown.** China's economy has weathered the Great Recession better than most other countries, and in the global economy has helped others, including the U.S., by providing much-needed consumer and business demand. In the last year and a half China's GDP and manufacturing has fell below target creating economic uncertainty. China's slowdown will be felt around the world and in the U.S.
- **Stagnation in Europe.** Europe has climbed out of the recession, but growth remains weak. Russia has threatened to cut off gas supplies which will have a significant effect on the economy as winter approaches.
- **Continued Sovereign Debt problems in the European Union.** Currently Italy and France are on a European Union watch list.
- **Instability in the Middle East.** The Middle East is unstable and has been for some time. Instability in this oil producing region contributes to the highly volatile oil market. A spike in oil prices will have noticeable effects on the world and National economy.
- **Domestic political gridlock.** The lack of agreement has diminished, to some degree, but political stalemate continues to be a real risk.

Local Economy:

Locally construction has been the biggest drag on the economic recovery because it was one of the industries most affected by the housing crash and the subsequent recession. However, construction has once again begun to expand, with large construction projects again changing the City's skyline. Downtown Bellevue has historically been dominated by office towers, but in the last decade people living in the downtown has increased drastically and is currently the fastest growing neighborhood in the City. New construction projects currently underway in the

2015-2016 Preliminary Budget

Economic Update

downtown area are primarily mixed-use projects fueling the downtown residential growth. It is vital to Bellevue's economy to grow both the residential base as well as the job base because it promotes local service businesses by having both daytime and nighttime customers. The large condominium and apartment projects also are providing a more affordable housing option for lower income residents. Before, to live in Bellevue meant living in one of the suburban neighborhoods which are some of the highest home values in the County. One of the problems facing Bellevue is the lack of affordable land, with higher property values; it is less financially viable for new single family housing developments. This is why single family residential construction has leveled off in recent months with most new single family home developments happening outside King County.

The Puget Sound economy has undoubtedly benefited from its geographic as well as business environment. Geographically, the Puget Sound is home to two significant ports, which are situated ideally for exports to and imports from Asia. IHS Global insight produces a Business Cost Index and the Seattle Tacoma Bellevue MSA has scored very close to the average. An average Business Cost Index coupled with the City's geographic advantage, as well as high tech and transportation businesses, makes the area very attractive for businesses to locate here.

| Metropolitan Statistical Area | Business Cost Index |
|--|---------------------|
| New York-Northern New Jersey-Long Island, NY-NJ-PA | 123.4 |
| San Francisco-Oakland-Fremont, CA | 121.8 |
| Boston-Cambridge-Quincy, MA-NH | 114.7 |
| Seattle-Tacoma-Bellevue, WA | 103.3 |
| Minneapolis-St. Paul-Bloomington, MN | 102.3 |
| Portland-Vancouver-Beaverton, OR | 102.2 |
| Houston-Sugar Land-Baytown, TX | 97.8 |
| Charleston-North Charleston-Summerville, SC | 95.8 |

Source: IHS Global Insight, June 12, 2014

Comparison MSAs were chosen by GDP/Capita, Size and Industry composition

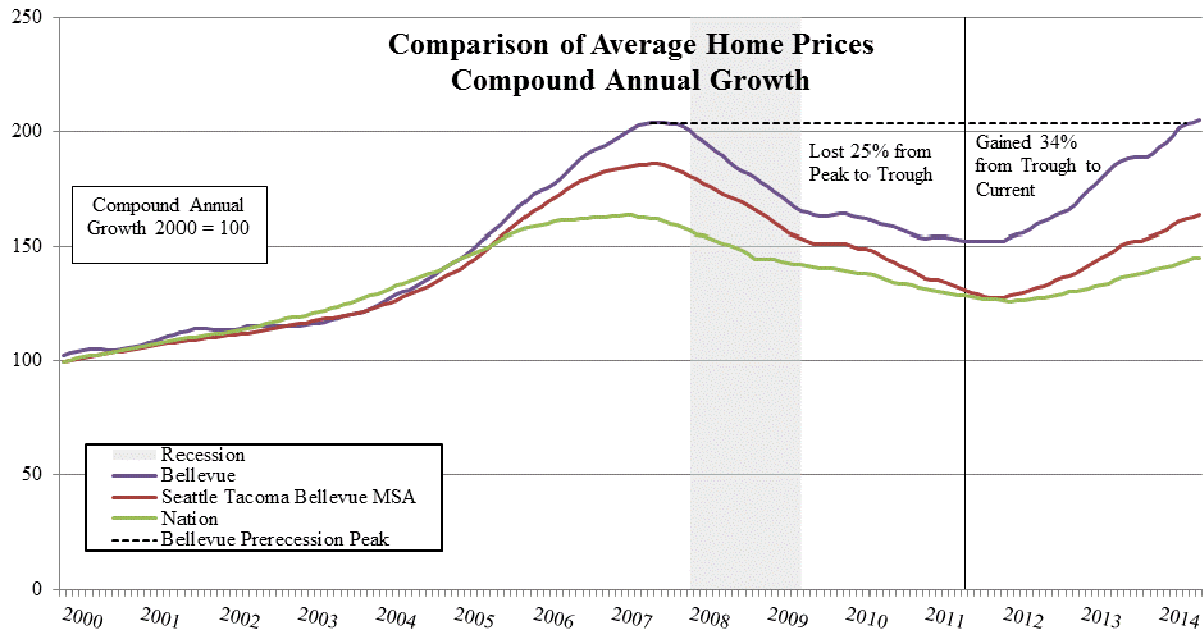
Business Costs are Based on Labor, Real Estate, Taxes and Energy

Average = 100

Bellevue home prices have rebounded much faster than the nation or even the rest of the Seattle Tacoma Bellevue MSA. Home prices have been a key measure to show how well the economy has recovered from the recession. Bellevue has now regained or surpassed the home value that was lost in the recession (not adjusted for inflation). (Source: Zillow Research (<http://www.zillow.com/research/>)) The housing market has heated up faring well with houses, some cases sitting on the market for only days. The increased housing activity is influenced by national school rankings, which increase a location's desirability and property values.

2015-2016 Preliminary Budget

Economic Update



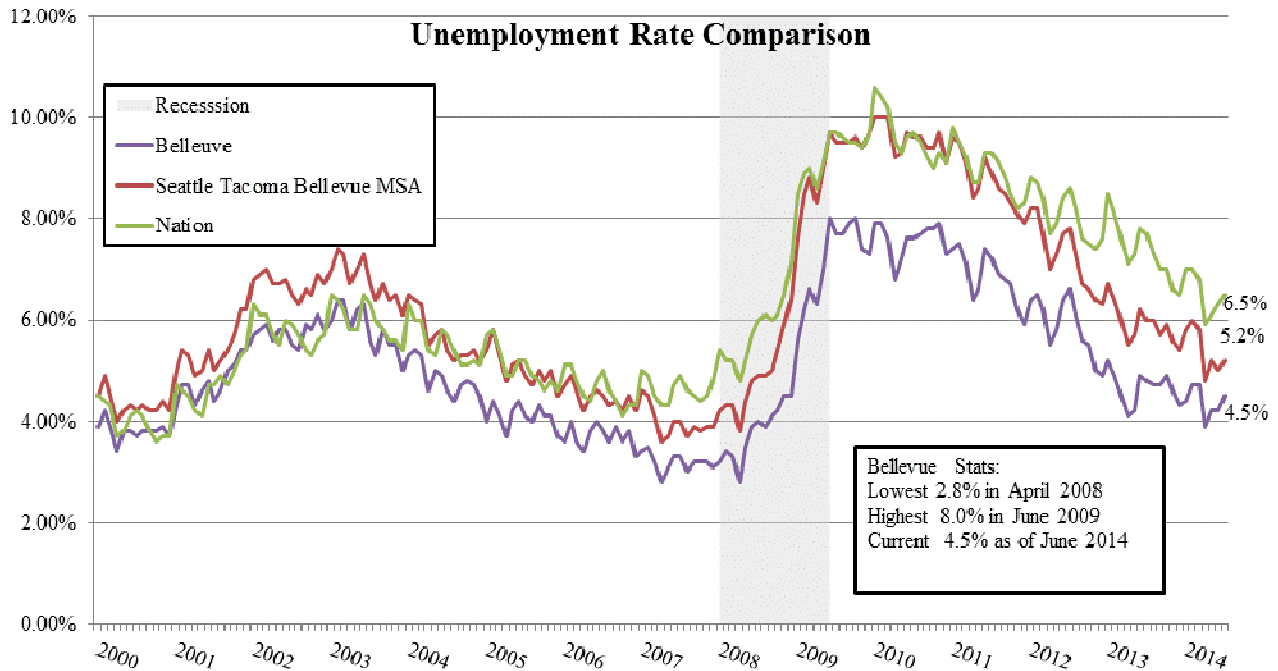
Zillow Research (<http://www.zillow.com/research/>)

Bellevue benefits greatly from its location in Puget Sound. The Puget Sound is known for its highly educated workforce and that is reflected in the types of jobs in Bellevue. The jobs requiring these highly educated workforce is reflected by 55% of the jobs being professional jobs requiring post-secondary education. The three of the top 4 job categories other than retail in Bellevue are Information at 13%, Professional, Scientific and Technical at 13%, and Healthcare and Social at 10%. Retail comprises 10% of jobs in Bellevue reflecting the strong retail presence, however retail generally does not require higher education it provides the services that are attractive for companies with good jobs to locate. (Source: Puget Sound Regional Council)

The US unemployment rate is currently 5.9%. Economists generally believe full employment is considered when unemployment is at 3%. Currently Bellevue's unemployment rate is at 4.5% which is significantly closer to full employment than the nation as a whole. (Bureau of Labor Statistics)

2015-2016 Preliminary Budget

Economic Update



Source: U.S. Bureau of Labor Statistics

Overall, the City's forecast assumes a modest recovery of tax revenue for the next few years, recognizing that the Puget Sound area's economy will continue to grow at a moderate pace. Sales tax is a good indicator of economic activity, and it has been growing at almost double the rate of inflation. It should be noted that the above-mentioned potential global and federal risks are not factored into the forecast at this time.

The City's mix of revenue consists of Property Tax, Sales Tax, Business and Occupation Tax (B&O Tax), Utility Tax, user fees, state-shared revenue, as well as other smaller revenue sources. Each of these revenue streams grow at different rates, some very slowly like Property Tax (based on new construction), and some at a greater rate such as Sales and B&O Taxes. Due to these differing growth rates, the relative impact of one revenue stream that may be growing at a rate greater than the others is offset by other revenue streams growing at a much slower rate. Sales and B&O Taxes, combined, comprise 36% of total General Fund revenue and are very sensitive to economic conditions. These taxes are forecasted to grow between 4% and 5% but, when combined with all other revenue streams including those less sensitive to economic conditions, are likely to grow at a rate slightly less than CPI. This means that for Sales and B&O Taxes to affect total revenue growth by 1%, Sales and B&O Taxes would have to grow by approximately an additional 3%.

Construction activity impacts the City's revenue in several ways and needs to have special consideration due to its complicated nature.

2015-2016 Preliminary Budget

Economic Update

- Construction in Washington is subject to sales tax and, unlike many other states, the firms doing the construction are subject to B&O tax. Property tax revenue will increase by the value of the new construction regardless of changes to the property tax rate.
- Construction activity is highly volatile and dependent on several factors such as the real estate market as well as the overall health of the economy.
 - Large construction projects contribute to the highly volatile nature of construction-derived revenue.
 - Additional factors are the availability of land and zoning capable of accommodating large construction projects.
 - Construction is a one-time activity. Eventually it will slow as demand diminishes or the City reaches build out.
- A residual effect of large construction projects is the sale of these multi- million dollar buildings well after construction has ceased. Companies that own large buildings often shift or change their portfolios dependent on going rate of return and interest rates. During the recession, real estate investment companies sold large office towers and other large developments that had unfavorable debt terms or rental income that was not covering their debt service; later these same companies began buying as the recovery was under way, with interest rates at historic lows and vacancy rates on a downward trend. These sales transactions are subject to Real Estate Excise Tax which funds the City's capital improvement program.